Lose the risk, gain the return

In our paper The US Hedging Advantage, we outlined reasons why US investors have neglected to manage currency risk in their portfolios. US investors often believe that currencies have zero expected return and, therefore, currency management is unnecessary.. Furthermore, investors mistakenly assume that currencies do not significantly affect a portfolio and any effect can be considered risk diversification that will, over time, result in a beneficial reduction of the portfolio's total risk.

Joe Hoffman, CFA
Chief Executive Officer
Currency Management

While most investors realize that currencies can contribute to risk, no action is taken to manage that risk contribution, even though the risk is uncompensated with no expected return. If an investor's aim is to create the most efficient portfolio by getting the greatest return for each unit of risk, then a prudent investor should minimize currency risk and reallocate that risk to an asset class with high return potential. In this paper, we clear up some common misconceptions surrounding currency risk management and show how investors can improve the efficiency of their portfolio by hedging currency risk.

A prudent investor should minimize currency risk that has no expected return and reallocate that risk to an asset class with high return potential.

Misconception 1: Zero expected return

Many investors assume currencies have zero expected return and thus believe that currency management is unnecessary. Figure 1 presents the cumulative return of the currencies in an EAFE portfolio from 1999 through January 2023. From 1999 through 2009, currencies appreciated over 22%, contributing to the portfolio's performance. From 2010 through January 2023, currencies depreciated by about 48%, significantly reducing the portfolio's return. Although currencies cycled back to 0% by early 2022, a period covering over two decades, most investors are evaluated over much shorter timeframes, annually if not quarterly. A prolonged period of underperformance can make it difficult to meet plan participants' investment expectations and result in criticism of the investment management strategy.

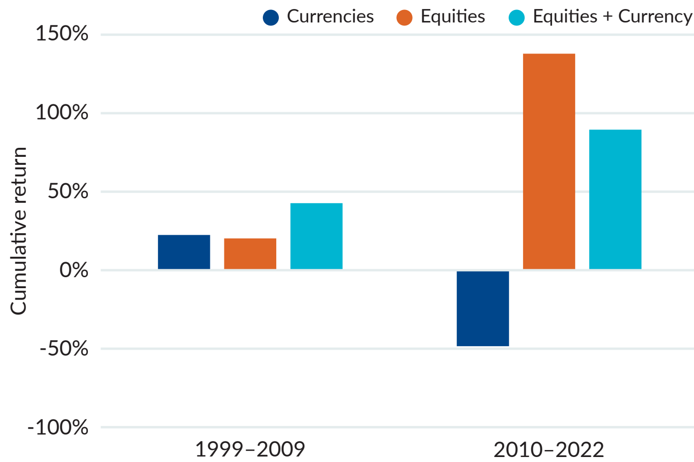
Investing internationally can result in an unintended investment in currency – investors invest in equities for the underlying equity exposure, not the associated currency exposure. If the return from currency is an inadvertent byproduct of the underlying equity exposure, the introduction of uncompensated risk should be hedged given the extended periods of rising and falling currencies that can and have occurred (Figure 2).

The information contained herein is intended for institutional clients, Qualified Eligible Persons, Eligible Contract Participants, or the equivalent classification in the recipient's jurisdiction, and is for informational purposes only. Nothing contained herein constitutes an offer to sell an interest in any Mesirow investment vehicle. It should not be assumed that any trading strategy incorporated herein will be profitable or will equal past performance. Please see the disclaimer at the end of the materials for important additional information.

FIGURE 1: **EAFE CUMULATIVE CURRENCY RETURN (JAN 1999 – JAN 2023)**

Source: Mesirow Currency Management and Bloomberg.

FIGURE 2: **EAFE CURRENCY EFFECT – CUMULATIVE RETURN**

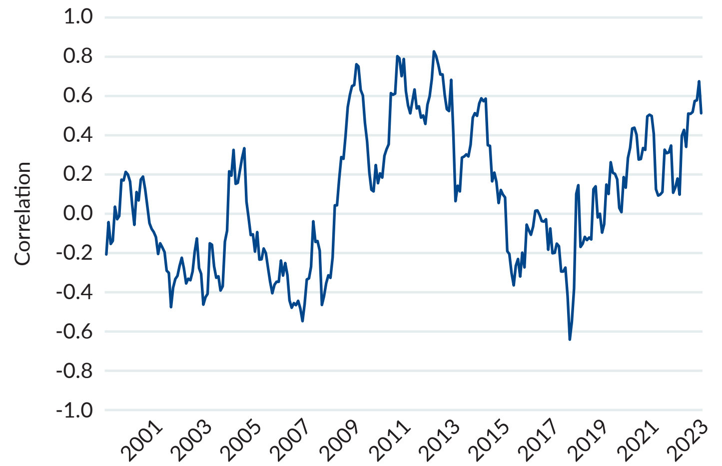


Source: Mesirow Currency Management and Bloomberg.

Misconception 2: Portfolio diversification

Investors believe that currencies diversify risk and thereby lower overall portfolio risk – this is not consistently the case. Figure 3 presents the 12-month rolling correlation between EAFE equities and their underlying currency exposures, demonstrating a wide range from negative correlation to near perfect correlation. While currencies did indeed diversify the EAFE portfolio risk during periods of negative correlation, this diversification benefit is not applicable in all market environments.

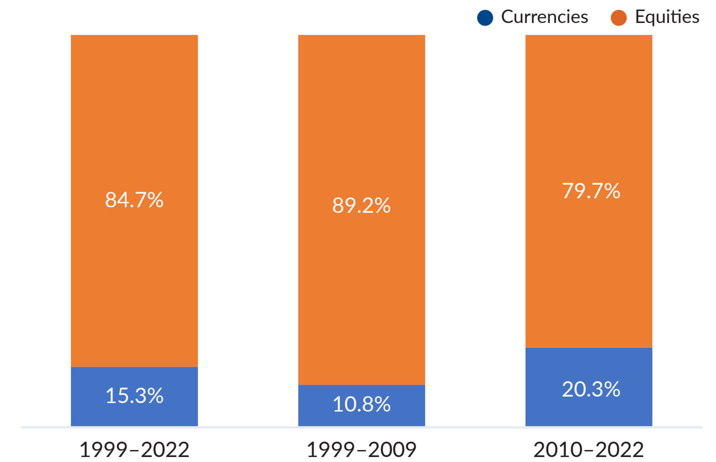
FIGURE 3: **12 MONTH ROLLING CORRELATION: EAFE EQUITIES AND CURRENCIES**



Source: Mesirow Currency Management and Bloomberg.

Furthermore, currencies contributed a substantial 15% of the total risk in an EAFE portfolio from 1999 through January 2023, and in shorter periods the risk can fluctuate significantly (Figure 4). From 1999 to 2009, currencies contributed 10.8% of the total risk, while from 2010 to 2022, the contribution increased to 20.3%.

FIGURE 4: **EAFE – CURRENCY AND EQUITY CONTRIBUTION AS % OF TOTAL RISK**



Source: Mesirow Currency Management and Bloomberg.

Misconception 3: Currency exposure is not significant

Because international equities are often a small allocation in a portfolio, some investors believe that the associated currency exposure has an insignificant effect on the portfolio's return or risk characteristics. Figure 4 shows, however, that currency risk can be a substantial contributor to overall portfolio risk.

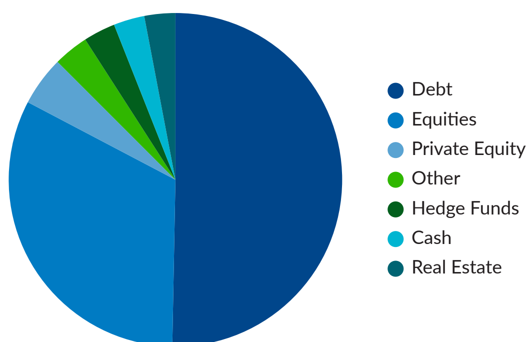
The world has become more integrated, encouraging investors to look for other investment opportunities, both in public and private equities, outside the U.S. As assets shift to private equity, investors cannot overlook the inherent currency exposure that might exist and its effect on portfolio returns.

PORTFOLIO EFFICIENCY

When a portfolio contains uncompensated currency risk and the investor's goal is to create the most efficient portfolio in terms of return for each unit of risk, an efficient strategy would involve hedging this risk and reallocating it to higher expected return assets that have similar portfolio risk as the unhedged currencies.

In WTW's 2021 pension fund survey, the average asset allocation of the largest pension funds (those pension plans with assets under management greater than $2.7 billion (Figure 5).[1]

FIGURE 5: **LARGEST PENSION FUNDS – AVERAGE ASSET ALLOCATION**



Source: WTW pension fund survey, 2021.

Considering these weights, we created a policy portfolio using the following indices:

- Cash – USD O/N Deposits
- Equities – MSCI World and MSCI Emerging Markets
- Debt – Bloomberg US Aggregate and ICE BofAML US high Yield
- Real Estate – NCREIF
- Private equity – Cambridge Associates Global Private Equity and Venture Capital
- Alternatives – HFRX Global Hedge Fund Index

Using the asset allocation weights from WTW's survey and the returns of these indices, we calculated the policy portfolio returns from March 2001 through December 2022 (Table 1). This portfolio's annualized return and risk were 5.52% and 7.56%, respectively, resulting in a return/risk ratio of 0.73.

In order to represent currency hedging in the equity portfolio, we used the same asset allocation as the policy portfolio but updated the equity piece using the returns of the MSCI World hedged to USD. The annualized return and risk registered at 5.47% and 7.11%, respectively. With the risk declining more than the annualized return, the return/risk ratio improved to 0.77 compared to 0.73 in the original portfolio.

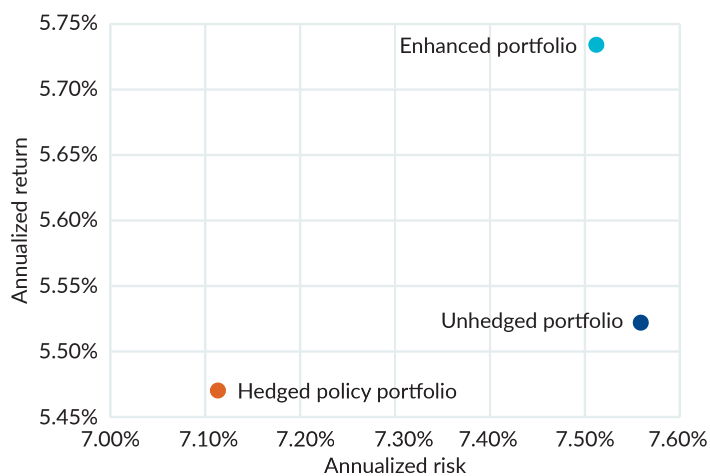
After hedging the currency risk and reducing the portfolio risk, the investor had 0.45% in annualized risk that could be reallocated elsewhere while maintaining the same risk profile as the original portfolio. There are several ways this risk can be allocated. For our example, we reduced the allocation to debt by 5% while increasing allocations to private equity by 2%, equity by 1%, US High Yield by 1%, and real estate by 1%.

In this new portfolio, which we will call the enhanced portfolio, the annualized return and risk registers at 5.73% and 7.51%, respectively, resulting in a return/risk ratio of 0.76. Although the return/risk ratio is only slightly lower than the hedged policy portfolio whose ratio was 0.77, the risk is essentially the same as the original unhedged portfolio AND the investor gained 21bps in incremental return per year. The enhanced portfolio also performed 26bps better than the hedged policy portfolio. Table 1 and Figure 6 present the return and risk characteristics of these portfolios.

TABLE 1: **RETURN AND RISK OF SAMPLE PENSION PORTFOLIOS – HYPOTHETICAL PERFORMANCE**

	Unhedged Portfolio	Hedged Portfolio	Enhanced Portfolio
Annualized return	5.52%	5.47%	5.73%
Annualized risk	7.56%	7.11%	7.51%
Return-risk ratio	0.73	0.77	0.76

FIGURE 6: **RETURN AND RISK OF SAMPLE PENSION PORTFOLIOS – HYPOTHETICAL PERFORMANCE**



Source: Mesirow Currency Management and Bloomberg.

Conclusion

The reasons for leaving currency risk unmanaged are no longer valid. Whether you believe currencies have a zero expected return or not, the swings in the currency market over extended periods can be dramatic, contributing substantial uncompensated risk to a portfolio.

Currencies in an international equity portfolio do not consistently provide risk diversification benefits. The correlation between EAFE equities and the underlying currency exposure has ranged from strongly correlated to negatively correlated. The portfolio risk contributed from currency has been approximately 15% of the total portfolio risk since 1999; since 2010, currency risk has contributed over 20% of the total risk in the portfolio.

As investors are looking for more investment opportunities, international assets offer attractive returns. As investors increase allocations to international assets, their portfolio exposure to currency will also rise. This currency exposure increase means that investors can benefit from a currency risk management program. The program can improve the efficiency of the portfolio by redeploying the risk saved from the currency hedge to higher return-seeking assets, such as equities, private equity, or real estate. Using this approach, investors can achieve a greater rate of return with the same risk as their original policy, resulting in improved efficiency and risk-adjusted returns.

About Mesirow

Mesirow is an independent, employee-owned financial services firm founded in 1937. Headquartered in Chicago, with locations around the world, we serve clients through a personal, custom approach to reaching financial goals and acting as a force for social good. With capabilities spanning Global Investment Management, Capital Markets & Investment Banking, and Advisory Services, we invest in what matters: our clients, our communities and our culture. To learn more, visit mesirow.com and follow us on LinkedIn.

1. Cash (3%), debt (50.3%), equities (32.4%), private equity (4.8%), real estate (3.0%), hedge funds (3.1%), and other (3.4%).

Mesirow Currency Management ("MCM") is a division of Mesirow Financial Investment Management, Inc. ("MFIM") a SEC registered investment advisor, a CFTC registered commodity trading advisor and a member of the NFA and Mesirow Financial International UK, Ltd. ("MFIUK"), authorized and regulated by the FCA. The information contained herein is intended for institutional clients, Qualified Eligible Persons and Eligible Contract Participants or the equivalent classification in the recipient's jurisdiction and is for informational purposes only. This information has been obtained from sources believed to be reliable, but is not necessarily complete and its accuracy cannot be guaranteed. Any opinions expressed are subject to change without notice. It should not be assumed that any recommendations incorporated herein will be profitable or will equal past performance. Mesirow Financial does not render tax or legal advice. Nothing contained herein constitutes an offer to sell or a solicitation of an offer to buy an interest in any Mesirow Financial investment vehicle(s). Any offer can only be made through the appropriate Offering Memorandum. The Memorandum contains important information concerning risk factors and other material aspects of the investment and should be read carefully before an investment decision is made.

Currency strategies are only suitable and appropriate for sophisticated investors that are able to lose all of their capital investment. This communication may contain privileged and/or confidential information. It is intended solely for the use of the addressee. If this information was received in error, you are strictly prohibited from disclosing, copying, distributing or using any of this information and are requested to contact the sender immediately and destroy the material in its entirety, whether electronic or hardcopy.

This communication may contain privileged and/or confidential information. It is intended solely for the use of the addressee. If this information was received in error, you are strictly prohibited from disclosing, copying, distributing or using any of this information and are requested to contact the sender immediately and destroy the material in its entirety, whether electronic or hardcopy.

Hypothetical model performance information and results do not reflect actual trading or asset or fund advisory management and the results may not reflect the impact that material economic and market factors may have had. Hypothetical performance results have many inherent limitations, some of which are described herein. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. In fact, there are frequently sharp differences between hypothetical performance results and the actual results subsequently achieved by any particular trading program. One of the limitations of hypothetical performance results is that they are generally prepared with the benefit of hindsight. In addition, hypothetical trading does not involve financial risk, and no hypothetical trading record can completely account for the impact of financial risk in actual trading. For example, the ability to withstand losses or adhere to a particular trading program in spite of trading losses are material points which can also adversely affect actual trading results. There are numerous other factors related to the markets in general or to the implementation of any specific trading program which cannot be fully accounted for in the preparation of hypothetical performance results and all of which can adversely affect actual trading results.

Comparisons to any indices referenced herein are for illustrative purposes only and are not meant to imply that a strategy's returns or volatility will be similar to the indices. The strategy is compared to the indices because they are widely used performance benchmarks.

The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. & Canada. It is maintained by MSCI Inc., a provider of investment decision support tools; the EAFE acronym stands for Europe, Australasia and Far East.

Australian Investors: The information contained herein is intended for Wholesale Clients only and is for informational purposes only. This document is not a prospectus or product disclosure statement under the Corporations Act 2001 (Cth) (Corporations Act) and does not constitute a recommendation to acquire, an invitation to apply for, an offer to apply for or buy, an offer to arrange the issue or sale of, or an offer for issue or sale of, any securities or investment service in Australia, except as set out below. The strategy has not authorised nor taken any action to prepare or lodge with the Australian Securities & Investments Commission an Australian law compliant prospectus or product disclosure statement. Accordingly, this strategy and document may not be issued or distributed in Australia other than by way of or pursuant to an offer or invitation that does not need disclosure to investors under Part 6D.2 or Part 7.9 of the Corporations Act, whether by reason of the investor being a 'wholesale client' (as defined in section 761G of the Corporations Act and applicable regulations) or otherwise. This document does not constitute or involve a recommendation to acquire, an offer or invitation for issue or sale, an offer or invitation to arrange the issue or sale, or an issue or sale, of any strategy or investment service to a 'retail client' (as defined in section 761G of the Corporations Act and applicable regulations) in Australia.

Canadian Investors: The information contained herein is intended for Permitted Clients only and is for informational purposes only. This confidential material pertains to the offering of the currency strategies described herein only in those jurisdictions and to those persons where and to whom they may be lawfully offered for sale, and only by persons permitted to sell such strategies. This material is not, and under no circumstances is to be construed as, an advertisement or a public offering of the strategies described herein in Canada. No securities commission or similar authority in Canada has reviewed or in any way passed upon this document or the merits of the strategies described herein, and any representation to the contrary is an offence.

EU Investors: The information contained herein is intended for Professional Clients as the term is defined by MiFID II and is for informational purposes only. Recipients that are classified under MiFID II as retail clients must opt up to Professional Clients before receiving any services from Mesirow Currency Management.

Japanese Investors: Mesirow Currency Management provides discretionary investment management services to managed accounts held on behalf of qualified investors only. MCM will not act as agent or intermediary in respect of the execution of a discretionary investment management agreement. Please note that this presentation is intended for educational purposes and solely for the addressee and may not be distributed.

Hong Kong Investors: The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the contents of this document. You should obtain independent professional advice prior to considering or making any investment. The investment is not authorized under Section 104 of the Securities and Futures Ordinance of Hong Kong by the Securities and Futures Commission of Hong Kong. Accordingly, the distribution of this Presentation Material and discretionary management services in Hong Kong are restricted. This Presentation Material is only for the use of the addressee and may not be distributed, circulated or issued to any other person or entity.

South Korean Investors: Upon attaining a client, Mesirow Financial Investment Management, Inc. ("MFIM") will apply for the appropriate licenses and retain the services of a local licensed intermediary (a Korean financial investment company). In the interim, MFIM will rely on and sub-delegate to Mesirow Advanced Strategies, Inc. ("MAS").

This material is not intended for investment nor distribution purposes, but is being provided to the addressee for educational purposes only. This book may contain privileged and/or confidential information and is intended solely for the use of the addressee. If this information was received in error, you are strictly prohibited from disclosing, copying, distributing or using any of this information and are requested to contact the sender immediately and destroy the material in its entirety, whether electronic or hardcopy. Nothing contained herein constitutes an offer to sell or a solicitation of an offer to buy an interest in any Mesirow investment vehicle or to invest in any strategy. Any offer can only be made to Qualified Professional Investors through the appropriate Investment Management Agreement or Offering Memorandum, which contains important information concerning risk factors and other material aspects of the investment and should be read carefully before an investment decision is made.

Mesirow Financial Investment Management, Inc. ("MFIM") is not making any representation with respect to the eligibility of any potential investors or recipients of this material to invest in or acquire any interests therein under the laws of Korea, including but without limitation the Foreign Exchange Transaction Act and Regulations thereunder. The investment or interests may only be offered to Qualified Professional Investors, as such term is defined under the Financial investment Services and Capital Markets Act, and no investment or any of the interests may be offered, sold or delivered, or offered or sold to any person for re-offering or resale, directly or indirectly, in Korea or to any resident of Korea except pursuant to applicable laws and regulations of Korea.

Singapore Investors: Mesirow Currency Management provides discretionary investment management services to managed accounts held on behalf of qualified investors only. MCM will not act as agent or intermediary in respect of the execution of a discretionary investment management agreement. Please note that this presentation is intended for educational purposes and solely for the addressee and may not be distributed.

Swiss Investors: Services are only offered to Regulated Qualified Investors, as defined in Article 10 of the Swiss Collective Investment Scheme Act. There can be no guarantee investment advice will be profitable or meet its investment objectives.

United Kingdom Investors: In the United Kingdom, this communication is directed only at persons who fall within the definition of a "professional client" as defined in COBS 3.5 of the FCA handbook.

Mesirow Financial refers to Mesirow Financial Holdings, Inc. and its divisions, subsidiaries and affiliates. The Mesirow Financial name and logo are registered service marks of Mesirow Financial Holdings, Inc., © 2023, Mesirow Financial Holdings, Inc. All rights reserved. Investment management services provided through Mesirow Financial Investment Management, Inc., a SEC registered investment advisor, a CFTC registered commodity trading advisor and member of the NFA, or Mesirow Financial International UK, Ltd. ("MFIUK"), authorized and regulated by the FCA, depending on the jurisdiction.